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SUBJECT: CYPRUS: Global Economic Turmoil Takes its Toll

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¶1. (SBU) Summary. Rising oil and food prices and the global economic turmoil is finally taking its toll on Cyprus. Cyprus is going to have to live with slower growth rates (albeit, still double that of the EU average), and to forget about fiscal surpluses. However, the main threat is inflation, which recorded a five-year high in May. Faced with a sharp deterioration in the economy and in its own finances, the government seems to be anxiously pressing all sorts of economic buttons in a search for additional revenue to fund the social programs it promised during the election campaign. The good news is that, thus far, the economy continues to grow, consumer and business confidence remain robust, and the government's lack of finesse has been limited to revenue enhancement in ways that do not affect Cypriot companies or consumers. End Summary.

Inflation on a Five-Year High

¶2. (SBU) Less than four months after coming to power (February 24), the Christofias administration is facing a considerably bleaker outlook for the Cypriot economy, primarily due to the deteriorating external environment. As in the rest of the EU, inflation is the main concern. Year-on-year inflation reached a five-year high for Cyprus of 4.9 percent in May 2008, against 2.2 percent in May 2007. Domestic price increases have been particularly strong in housing and utilities, including electricity (7.3 percent); transportation (6.5 percent); and foodstuffs 6.4 percent). Depending on how oil and cereal prices behave over the next few months, year-end (2008) inflation in Cyprus is expected to be above 4.0 percent.

¶3. (SBU) According to Eurostat, inflation in the EU 27 for April (latest month available) averaged 3.6 percent, against 4.3 percent in Cyprus. One of the main reasons inflation is higher in Cyprus than in the rest of the EU is Cyprus' complete dependence on imported oil. Eurostat placed Cyprus at the very top of the list of EU 27 countries in terms of oil dependency, with an overall dependency score of 100.7 percent, against an EU average of 52.7 percent. Public transport in Cyprus, whether inter-city or intra-city is virtually non-existent, so Cypriots rely almost exclusively on privately-owned vehicles for their transportation (with a resident population in the south of 780,000 people, Cyprus has around 600,000 registered motor vehicles). Additionally, Cyprus has done little to adopt renewable or more environment-friendly energy sources (like natural gas), falling far short of its Kyoto commitments to the European Commission.

¶4. (SBU) Further exacerbating inflation is the legally-mandated Cost of Living Allowance (COLA). The COLA adjusts wages fully for inflation twice a year. It covers employees across the board and is considered a sacred cow by unions, which wield considerable power in Cyprus, with support from most political parties. Anyone suggesting

that the COLA should be amended gets pilloried immediately, as Central Bank Governor Orphanides found out recently (reftel). The result is a wage indexation system that most economists here believe may be good for the employees' sense of social justice but is bad for the economy's competitiveness and feeds inflation and the bloated government payroll.

Construction, Tourism, and Retail Trade Down

¶5. (SBU) Building permits issued during the period January-March 2008 recorded a 16.2 percent decrease compared to the corresponding period of 2007. The total value of these permits decreased by 8.9 percent, and the total area by 11.3 percent. Government tax revenue from property transactions also took a 17 percent nosedive in the first four months of 2008 compared to the same period in 2007. Yet, property prices in Cyprus have risen by 3.3 percent during the first quarter of 2008, with just a hint of a slow-down in March, defying the global pattern, at least for the time being. Faced with a property slowdown, the Central Bank in early June lifted restrictions on property loans for second homes, imposed a year earlier when the property market was still booming.

¶6. (SBU) Tourism revenue, the life-blood of the Cypriot economy, recorded a 5.0 percent decrease during the first four months of 2008, largely because of a 12.2 percent decrease in spending per head by British tourists who constitute Cyprus' main market. Cyprus' competitiveness in this crucial sector has been eroding over the last seven years, due to increasing overheads and increasing competition from such nearby markets as Turkey and Croatia.

¶7. (SBU) Meanwhile, retail consumer spending also seems to be slowing down. According to the Cyprus Department of Statistics, the Value Index of Retail Trade fell from 147.5 points in January 2008 to 145.4 points in February in a reversal from a multi-year upward trend.

Loans and Foreign Travel Up

¶8. (SBU) At the same time, rather incongruously given the apparent slow-down in the economy, bank lending is at an all-time high. Credit expansion has been very strong since the beginning of the year, exceeding 30 percent. By April 2008, total lending surged by a record 35.4 percent to Euros 44.5 billion in April 2008, compared to April 2007. The two main components of this increase have been loans to businesses (non-financial institutions), which rose by 47.3 percent and housing loans, which rose by 38.0 percent. In particular, lending to businesses reached Euros 21.5 billion in April 2008, roughly twice the April 2006 level (Euros 12.7 billion). According to banking sources, increased business lending went towards financing business development and expansion plans as well as to provide extra liquidity. Interestingly, Cypriot businesses are borrowing at an interest rate of 6.63 percent - one of the highest in the EU, against a Eurozone average of 5.91 percent. Banks and analysts are warning businesses to be very mindful of the risks involved in increased borrowing, especially during a period of economic turmoil. Over the same period, total bank deposits reached Euros 55.4 billion in April 2008, recording an increase of 24.5 percent.

¶9. (SBU) Another sign that the Cypriot economy is not in a recession is that travel abroad by Cyprus residents during the first four months of 2008 recorded a 15.2 percent increase, and there has been no increase in unemployment.

Growth Down, Fiscal Surplus Vanishing Quickly

¶10. (SBU) Against this backdrop, the Ministry of Finance recently revised downwards its economic performance targets for 2008. The rate of growth, estimated at 4.0 percent in February, is now anticipated to reach only 3.5 percent. This is still about twice the EU average but it marks a considerable deceleration from last year's 4.3 percent growth.

¶11. (SBU) Just a few months ago, the government was expecting a

fiscal surplus of 0.5 percent for 2008, following last year's surplus of 3.3 percent. In early June, Finance Minister Stavrakis said that ending 2008 with a surplus would be challenging. Government revenue from the once-booming property market, was down 17 percent in the first four months of 2008. On the expenditure side, the government paid out Euro 33 million to pensioners as an Easter bonus, as soon as it come to power. The government will also need to spend Euro 30 million on a civil service pay increase and another Euro 40 million for the importation of water via tankers from Greece to deal with the current severe drought.

¶12. (SBU) In an effort to stay in the black, the government has turned its attention to past-due taxes amounting to Euros 480 million. However, up to a third of this is probably not recoverable since the businesses owing the taxes are now bankrupt. The biggest debtor to the government, at least from the government's point of view, is the Church of Cyprus.

Government Confronts Church Over Taxes

¶13. (SBU) In early June, the government and the Church had a very public confrontation over whether or not the Church owes the state any taxes. The Ministry of Finance claims that the Church owes Euros 111 million in taxes (Euros 58 million property tax, Euros 10.2 capital gains, and Euros 42.7 million in past taxes). Archbishop Chrysostomos stridently denied that the Church was a tax dodger, pointing to an agreement with the previous administration dated December 27, 2005, which, according to the Archbishop, settled this matter once and for all. Chrysostomos concluded: "They are not getting a single Euro out of us; we do not owe them anything." During the exchange, both sides exchanged some rather pointed comments, including the Archbishop blasting the government for populist antics. Previous administrations have also tried to get the Church to pay taxes, but this is the first time the confrontation between them has been so acrimonious.

¶14. (SBU) As a result of the confrontation, the Church felt compelled to call a press conference and disclose, for the first time ever, the full picture of its finances. According to this disclosure, at the end of 2007, the Church had fixed assets of Euros 1.1 billion, including Euros 600 million in property holdings; Euros 58 million in hotels, and Euros 383 million in shares and other investments. By the Archbishop's own admission, the property figure is based on older valuations; a more current valuation would raise the property figure to "billions of Cyprus Pounds." Comment: The issue seems to revolve around whether property taxes are payable by the Church on its vast (for Cyprus) unutilized property holdings. The Church had previously agreed to pay taxes on income earned from its holdings in brewery, hotel, winery, and banking operations on the island. End Comment.

Government Eyes Central Bank Gold

¶15. (SBU) On June 7, Finance Minister Stavrakis met with officials from several parties regarding the economy. Stavrakis warned 2009 would be a hard year for the economy. He explained that a fiscal surplus would be unlikely for 2009, and the government was focusing on keeping the deficit to a minimum. Stavrakis noted further that, based on current conditions, the government would be in a position to undertake only about 40 percent of the development programs it had pledged to carry out for the next five years.

¶16. (SBU) Stavrakis used this as an introduction to recruit cross-party support to the government's effort to require the Central Bank to sell off its gold reserves, which amount to Euros 250 million. According to the press, the government has been trying for the past two months (initially behind the scenes, but publicly since the story was leaked to the press on June 8) to convince the CB to sell off its gold reserves to "realize a profit." Existing legislation stipulates that, if the CB sells off reserves, the proceeds are to be divided as follows: 80 percent to the government's consolidated fund, and 20 percent to the CB's reserves. Based on this provision, the press speculated that the government intended to keep Euros 200 million for itself, and give the CB the remaining Euros 50 million. The government quickly responded that this was not its intention at all and that it wanted to sell the

gold in order to help pay off the public debt to alleviate the burden on the economy. (Comment: This excuse is probably nothing but an afterthought on the part of the government. At Euros 8.6 billion or 52.5 percent of GDP, Cypriot public debt is quite manageable and on its way down without any extra help. It is also within the Maastricht ceiling of 60 percent. End Comment.)

¶17. (SBU) The CB has resisted this effort. (Some have even suggested that this refusal was the real reason behind the recent tension between the government and CB Governor Orphanides, and not his suggestion to amend the COLA.) With the exception of the ruling AKEL party and its coalition partner DIKO party, none of the parties expressed support for selling off gold reserves. Opposition party DISY, in particular, launched severe criticism against the government's intention. Challenged to comment on why the government was pursuing this issue at this point in time, Stavrakis responded, "We are a new government; we have every right to start with a clean slate and examine things critically."

¶18. (SBU) We asked a senior CB contact for comment. He responded that the CB's main policy guideline when it came to managing its reserves, vis-`-vis the European Central Bank, was that the CB maintained "adequate" reserves to conduct its business and meet its obligations. He stressed further that the CB was not a speculative institution - it manages Cyprus' reserves with a view to hedge against risk and to keep enough for a rainy day, in case of a real catastrophe. (Cyprus' official international reserves were around Euros 4.0 billion at the end of 2007; gold makes up only about 6.0 percent of this.) He described the government's suggestion to sell off gold now to realize a "profit" as "misguided" at best, given that the government is not facing an immediate or dire fiscal deficit. He also commented that the debate over the gold reserves should have been kept away from the public domain. If nothing else, the media are often not sufficiently informed about these issues. Furthermore, he noted, to even call this a "profit" (given that gold now sells for USD 900 an ounce, compared to USD 40 an ounce when acquired in 1963) - as the papers have done quoting AKEL sources -- betrays a basic lack of understanding of the CB's role.

¶19. (SBU) Comment: When this administration won the February 24 election, the Cypriot economy was in a clearly enviable state. Less than four months later, this is true only in relative terms: high inflation, a quickly-vanishing fiscal surplus, restrained consumption, and a rapidly-slowing growth rate make up the present picture. It may be tempting to blame the present administration for the significant deterioration in the economy since the February 24 Presidential elections. However, the truth is that the government took over just at a time when the Cypriot economy was already poised to decelerate due to the deteriorating external circumstances.

¶20. (SBU) Comment Continued. Far from being in a recession, the Cypriot economy continues to grow at a satisfactory level, especially compared to the rest of the EU. So the real issue here is not so much how bad the economy is but rather with what confusion the government seems to be reacting to its first unfolding economic crisis. By most people's reckoning, its reaction so far can only be described as "clumsy." Simultaneously pressing the hot buttons of both the Church and the Central Bank has unified those from a very broad political spectrum to question the new government's economic management skills. Most disturbingly, the Finance Minister, who as a senior banker was brought in to lend his economic credentials to the nominally communist regime, is seen by many as failing to restrain the non-orthodox economic tendencies of his government. End Comment.

SCHLICHER